THE FY 2000 AND FY 2001 LEGISLATIVE BUDGET RECOMMENDATION

Summary

This section provides a summary of the following major issues in the Legislative budget recommendation for FY 2000 and FY 2001:

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FY 1999 Balances

When the Legislature approved the FY 1999 budget in April 1998, the expected beginning balance was $523.3 million. The actual beginning balance proved to be $525.8 million. While revenues were lower than anticipated in FY 1998, revertments of unused General Fund appropriations were higher than anticipated. These two factors balanced one another out, leaving the FY 1999 beginning balance near the original projection.

In April 1998, the estimated FY 1999 ending balance was $13.0 million. The balance is now expected to climb to $69.4 million due to higher than anticipated revenues. Individual income and sales tax revenues are running higher than expected, offset somewhat by lower corporate income tax returns.

Economic Forecast

The prognosis for the national economy remains good. Despite the age of this eight-year expansion (second longest in the post WW II era), the classic warning signs of a recession are not on the horizon. Inflation is expected to remain very low, so there should not be a need for an increase in interest rates to keep it in check. In general, economists foresee the national economy continuing to grow, although at a slightly slower pace than the recent past.

The forecast for the Arizona economy remains even better than the national forecast. We anticipate the state economy will continue to grow at a faster rate than the nation as a whole. As with the national economy, however, the state's growth rate should moderate over the next 30 months. State revenue growth, which follows the direction of trends in the economy, is expected to mirror this trend.

The Legislative budget is based on the Executive's base revenue forecast. Between FY 1999 and FY 2001, the Executive and JLBC Staff revenue forecasts differ by $83.6 million, or less than one-half of 1%. As a result, the Legislative budget utilizes the Executive base revenue forecast to minimize the differences with the Governor on technical estimates.

The economic and revenue forecast is described in more detail in a section at the end of this book.

The Budget Backdrop

While revenues will continue to grow, the state will actually have fewer total General Fund resources in FY 2000 than in FY 1999. This anomaly is due to the decline in the state's General Fund surplus, which has been used to finance the on-going obligations of state government. As noted above, the $525.8 million surplus at the beginning of FY 1999 will drop to less than $70 million by the beginning of FY 2000. After adjusting for revenue growth and the surplus reduction, the state's total FY 2000 General Fund resources will be $133 million less than in FY 1999. *(See Table 1.)*

Table 1

The FY 1999 and FY 2000 Total Resources
($ in Millions)

	FY 1999	FY 2000
Beginning Balance	$526	$69
Base Revenues	5,430	5,754
Total Resources	$5,956	$5,823

Among other adjustments, the Legislative budget recommendation reduces overall state spending by $89 million to keep the budget in balance for FY 2000. In the midst of this overall reduction, funding has been preserved for several of the following initiatives.

Students FIRST

The Legislative budget continues the commitment to school facility construction begun in the Students FIRST legislation. As originally enacted, the Legislature committed $362.2 million to Students FIRST in FY 1999. In FY 2000, this budget would provide $370.2 million, followed by $393.6 million in FY 2001. Across the 3 years, a total of $1.1 billion is being provided from the General Fund for Students FIRST. *(See Table 2).*

The centerpiece of the Students FIRST legislation is the New School Facilities Fund. Originally funded at $200 million in FY 1999, the Legislative budget retains that funding through FY 2001. The Executive would only provide new funding of $90 million in FY 2000, reflecting the availability of $110 million in unused FY 1999 monies.

This lower funding level, however, may understate actual needs. The School Facilities Board has yet to receive an in-depth report of district building requirements. In addition, the Board has not established its minimum school facility adequacy guidelines, which are due by April 30, 1999. As a result of this uncertainty over the final cost estimates, the Legislative budget has retained the $200 million commitment to new school construction.

The Legislative budget also retains the use of pay-as-you-go financing for school construction. Since the advent of its fiscal reform efforts in the mid-1990's, the Legislature has relied almost exclusively on cash financing for major new construction projects. Cash financing will avoid the expense of interest payments over the next 10 years. At a 5% rate for a 10-year bond, the state would incur approximately $55 million in total interest payments for each $200 million revenue bond.

The use of revenue bonding in a period of relative fiscal health also reduces the state's ability to use this option should economic conditions decline in the future. Future recessions could cut the state's revenue growth rate. If revenue bonding is used from the inception of Students FIRST, this option would not be available as a means of addressing any future economic contingency.

Table 2 FY 1999 - 2001 General Fund Contribution to Students FIRST ($ in Millions)

	FY 1999	FY 2000	FY 2001
New School Facilities	$200.0	$200.0	$200.0
Deficiencies Correction	35.0	35.0	50.0
Building Renewal Fund	75.0	82.5	87.5
SFB Operating Budget	3.2	1.2	1.2
ADE Soft Capital/Charter Assistance	49.0	51.5	54.9
Students FIRST Total	$362.2	$370.2	$393.6

Tax Reductions

The Legislative budget provides for an additional $20 million in new tax reductions in FY 2000 and another new $20 million tax package for FY 2001. With these new reductions, the Legislature will have reduced taxes for eight consecutive years – from FY 1994 to FY 2001. The details of the new tax reduction packages will be developed throughout the course of the legislative session.

The Legislature has already approved $66.4 million in new tax reductions for FY 2000. In large measure, these additional reductions are due to the full year phase-in of the Tax Relief Act of 1998. In combination with the $20.0 million of newly proposed reductions, the total dollar value of all FY 2000 tax reductions would be $86.4 million.

The Legislature is also financing another $23.4 million in local property tax relief through higher Basic State Education Aid payments to school districts. This amount relates to previously enacted legislation concerning truth in taxation, accelerated depreciation and multiple site locations.

Legislative Priorities - The Box

The Legislative budget includes $45 million in FY 2000 and another $65 million in FY 2001 to fund legislative priorities. In legislative parlance, these dollar amounts represent "The Box." This funding could go to items such as K-12 education enhancements or a state employee pay raise as well as any other bills funded outside of the budget process during the legislative session.

K-12 education enhancements could take any number of different forms. As an example, every $1 increase in the base support level would cost the state $1 million.

A state employee pay raise could also be implemented in various ways. The cost of a traditional 1% increase in state employee pay on January 1, 2000 would be $8 million for 6 months. This cost may be reduced if the pay raise is associated with personnel reform. The Legislative budget, however, does not specify any particular expenditures from the priority set-aside.

Operating Budgets

The Legislative budget increases agency spending from the General Fund in FY 2000 by $48.9 million, or 0.9%. The budget further increases spending by another $169.7 million, or 2.9% in FY 2001. These amounts exclude the Legislative priority spending discussed above. A substantial portion of the new funding results from:

- Funding the Department of Education K-12 education formulas, at a cost of $43.6 million in FY 2000 and $37.6 million in FY 2001.

- Opening new prison facilities, at a cost of $23.2 million in FY 2000 and $9.5 million in FY 2001.

The budget also increases spending for the Department of Health Services by $7.0 million in FY 2000 and $10.7 million in FY 2001. The substantial portion of these increases would fund improvements at the Arizona State Hospital in an attempt to regain the facility's Medicare certification.

Additional detail on agency operating budgets appears in the next section of this report. Even further detail can be found in the separate Analysis and Recommendations volume.

Capital Outlay

The Legislative budget recommends $12.4 million in FY 2000 and $11.2 million in FY 2001 from the General Fund for Capital Outlay projects. The main component of the recommendation is Building Renewal funding for the repair and maintenance of state buildings. Of the total capital budget, $9.5 million in FY 2000 and $10.5 million in FY 2001 would fund 23% of the estimated Building Renewal formula.

The Legislature will also need to consider funding for a new state prison complex during the upcoming session. The Legislative budget does not set aside any General Fund monies for this purpose during the biennium, but would appropriate $21.0 million in both FY 2000 and FY 2001 from the Corrections Fund to begin construction of a new 4,200 bed facility. Additional federal grants totalling approximately $20.5 million in FY 2000 and $9.5 million in FY 2001 should also be available for prison construction. The Legislature, however, would have to first site any new prison and determine whether it should be a publicly or privately run facility.

The Legislature may also want to consider several new health facilities in the upcoming session. At a minimum, the growing Sexually Violent Persons program will need an additional facility by FY 2000. There is also interest in a new Arizona State Hospital facility and a State Health Laboratory. The Executive has proposed funding all three facilities with Tobacco Settlement monies, which are described below.

Excess Balance Transfers/Reversions

While using the Executive's base revenue forecast for the Legislative budget, the JLBC has made two further adjustments. The first adjustment is the transfer of excess fund balances and the reversion of unused appropriations to the General Fund.

The Legislative budget transfers $31.6 million from excess balances in 27 funds to the General Fund in FY 2000. An additional $2.0 million would be transferred to the General Fund in FY 2001. See the Budget Detail section of this volume for a listing of these funds and the recommended transfers. There are over 512 funds in state government. Since many of them do not undergo the same scrutiny as General Fund expenditures, their fund balances can build up over time. These transfers focus on the funds with the largest balances. In most circumstances, only a portion of the fund balance is recommended to be transferred so as to minimize the impact on program operations. The Legislature approved similar fund transfers in 1989 and 1992.

The Legislative budget also increases revertments by $2.5 million in FY 1999 by eliminating unused appropriations in certain accounts. See the Budget Detail section for a listing of these recommended revertments. Three capital outlay projects would contribute $1.9 million of these reversions. They involve a Capitol Mall Office Building, a State Health Laboratory and the Arizona State Hospital. There is no current plan in the Legislative budget to proceed with the Capitol Mall Building. The Governor has proposed using tobacco settlement monies for the Health Laboratory and the State Hospital.

Urban Revenue Sharing

As a second adjustment to the Executive revenue forecast, the Legislative budget retains the current structure of the urban revenue sharing (URS) program. Cities and towns currently receive 15.0% of income tax revenues under the URS program. Given the expected growth in income tax collections, these localities will receive $358.6 million in FY 2000, an increase of $18.2 million, or 5.4%. URS is expected to grow to $379.5 million in FY 2001, an increase of $20.9 million, or 5.8%.

As a result of a 1972 general election ballot initiative, incorporated cities and towns have received a share of total net income tax collections since FY 1974. In exchange, cities and towns are not allowed to levy income and luxury taxes. While providing cities and towns with an added revenue source, URS was also designed to simplify tax administration by prohibiting a proliferation of city-specific taxes.

The amount of shared revenue is based on net income tax collections 2 years earlier. The specific distribution to cities and towns is based on their proportion of the population. This proportion is determined by a decennial census, mid-decade census or other approved estimate. In practice, the population base for each city has changed every 5 years. Adjustments are also made for annexations.

The original ballot initiative required 15.0% of income tax collections to be shared with cities and towns. In order to avoid an unintended windfall when state personal income taxes were increased in the early 1990's to help balance the budget, the URS distribution was lowered from 15.0% to 12.8% in FY 1993. As a result of several state income tax rate cuts, the Legislature agreed to increase the urban revenue share to 13.6%, effective in FY 1997, to offset the loss of revenue associated with state income tax reductions. The distribution percent was increased to 15.0%, starting in FY 1998.

In total, URS fell below 15.0% from FY 1993 to FY 1997. From FY 1992 to FY 1997, URS still grew from $176.1 million to $257.8 million, an increase of $81.7 million, or 46.4%.

Laws 1997, Chapter 8, 1st Special Session, increased the URS from 15.0% to 15.8% beginning in FY 2000. Under that new percentage, cities and towns would receive $376.0 million in FY 2000, an increase of $35.7 million, or 10.5% over FY 1999. Cities and towns would receive $395.0 million in FY 2001, an increase of $19.0 million, or 5.1%.

The Legislative budget recommends permanently retaining the current 15.0% rate of sharing. This percentage is consistent with the original 1972 ballot initiative and will provide the localities an additional $39.2 million, or 11.5%, during the FY 2000 and 2001 biennium. During the same time period, state expenditures are expected to increase by 2.5%. Table 3 shows the recent history of urban revenue sharing.

Table 3

Urban Revenue Sharing in the 1990's
($ in millions)

Fiscal Year		$ Shared	%Growth 1/	% Shared 2/
1990		150.6	4.6%	15.0%
1991		166.9	10.8%	15.0%
1992		176.0	5.5%	15.0%
1993		183.7	4.3%	12.8%
1994		185.4	0.9%	12.8%
1995		205.6	10.9%	12.8%
1996		218.5	6.3%	12.8%
1997		257.8	18.0%	13.6%
1998		291.2	13.0%	15.0%
1999		340.3	16.8%	15.0%
2000	A	358.6	5.4%	15.0%
	B	376.0	10.5%	15.8%
2001	A	379.5	5.8%	15.0%
	B	395.0	5.1%	15.8%

1/ Growth in URS over prior year
2/ % of income tax shared with localities
A/ JLBC Recommendation
B/ Current Statute

Tobacco Settlement

The Legislative budget makes no specific recommendations for the use of any monies from the recently announced tobacco settlement. A spending plan will need to be developed during the 1999 session as the Legislature considers legislation relating to the settlement agreement. Prior to receiving any settlement monies, the settlement must be approved by the state court.

In November 1998, Arizona signed a settlement agreement in its lawsuit with tobacco companies. The state joined 30 other states in suing tobacco companies for reimbursement of the cost of medical care provided to indigent tobacco users. Arizona will receive approximately $2.8 billion over the first 25 years of the agreement.

The settlement includes one-time, or "up front" payments of $177 million, which will be paid over 5 years beginning in FY 1999. The agreement also includes annual payments in perpetuity. The amount of the annual payments grows from $59 million in FY 2000 to $188 million by FY 2018. The estimated total annual revenues from the settlement (up-front and annual payments) are shown in Table 4.

Table 4

Tobacco Settlement Revenues
($ in millions) 1/

Fiscal Year	$
1999	35.4
2000	94.5
2001	102.0
2002	122.5
2003	123.7
2004-2007	103.2
2008-2017	105.3
2018-2024	118.0

1/ Based on Executive estimates. Monies may not be received until FY 2000.

The Executive has made a recommendation for expending the entire tobacco settlement amount (see the AHCCCS section of the Analysis and Recommendation book for further information on the Executive's proposal). As noted above, the JLBC has not made a recommendation for expending the settlement monies. At a minimum, the Legislature may want to consider the use of these monies for an additional Sexually Violent Persons (SVP) facility. The population is currently housed at the Arizona State Hospital, but will outgrow its space by the end of FY 2000.

As a result of this agreement, tobacco companies raised the prices of tobacco products. This increase in cost will likely result in decreased tobacco sales, thereby reducing revenue to Arizona's Tobacco Tax and Health Care Fund. The JLBC estimates for the Tobacco Tax assume decreased revenue to reflect lower tobacco sales.

Stabilization Fund Deposits

The FY 2000 Legislative budget does not deposit or withdraw funds from the Budget Stabilization Fund (BSF). The funding formula for the BSF requires that a withdrawal should occur whenever the adjusted annual growth rate of total state personal income is more than (2.0)% below the most recent seven-year growth average. Current projections indicate that this threshold will not be reached in FY 2000. The balance in the BSF will be about $402.5 million at the end of FY 2000, or at the statutory maximum of 7.0% of prior year revenues.

The FY 2001 Legislative budget also does not require either a deposit or withdrawal from the Budget Stabilization Fund. Current projections do not foresee an adjusted growth rate of personal income that is more than (2.0)% below the seven-year average of state personal income. The BSF balance, including accrued interest, will be about $422.6 million at the end of FY 2001, which will represent 7.0% of estimated prior year revenues.

Budget Reform

Laws 1997, Chapter 210 requires that the state budgeting process be converted to a 2-year cycle, beginning with FY 2000. In each odd-numbered year, the Legislature will approve budgets for the 2 succeeding fiscal years. This change from annual budgeting will enable legislators to spend more time on program evaluation and other legislation during the second regular session.

Chapter 210 also requires each agency to submit its budget request using its program structure. All budget units are to convert to program budgeting by FY 2006. This change will allow the Legislature to examine a list of programs representing the most important activities of an agency, rather than line items of expenditure, such as Personal Services and Travel. As required by statute, the JLBC Staff and OSPB issued a schedule delineating the year in which each budget unit shall begin submitting a program budget. The JLBC Staff and OSPB agreed upon a 3-phase migration schedule, beginning with this year's Appropriation process.

Phase I includes 60 agencies that JLBC and the Executive have recommended as program budgets for the FY 2000/FY 2001 biennium. For most of these agencies, no change is required for program budgeting because they have only 1 program. For the remaining 15 Phase I agencies with more than 1 program, there is a program summary in the JLBC recommendation narrative. This lists the dollar amounts recommended for each program by the JLBC and the Executive. The JLBC recommendation also shows the traditional line item expenditure detail below this program summary.

The program migration schedule includes 37 budget units for the FY 2002/FY 2003 biennium (Phase II) and 15 budget units for the FY 2004/FY 2005 biennium (Phase III). However, given that there are currently 3 times as many programs and subprograms as budget cost centers, requiring agencies to submit a full set of schedules for each program would be impractical. The JLBC Staff and OSPB have acknowledged that the migration schedule may need to be revisited, pending agreement on the level of detail to be required in agency budget submissions.

An important aspect of moving to program budgeting is the linking of results-oriented performance measures to budgetary decisions. Each JLBC recommendation includes up to 5 performance measures per cost center, selected largely from the measures provided by each agency. Agencies have been submitting these performance measurements for 5 years, but this is the first time that the JLBC Recommendation Book has extensively used this information. Although agencies have upgraded the quality of their measures over time, there is a need for substantial improvements. As the House and Senate Appropriations Committees consider the budgets, they may determine additional performance measures that would be useful in the Appropriations process.

Chapter 210 also made the Program Authorization Review (PAR) process permanent. The state has completed 3 PAR cycles, reviewing 18 programs in 1996, 34 programs in 1997, and 36 programs in 1998.

The next PAR cycle was to begin with agency self-assessments in the current year, followed by JLBC Staff and OSPB analysis, and then legislative review in 2000, during the Second Regular Session. However, the Legislature chose not to enact a bill specifying programs for this PAR cycle. The House of Representatives has established a standing PAR Committee, which will consider changes to the current process.

The PARs need to be more timely and more interactive with legislators. Under the current calendar, PARs are selected almost two years prior to when the program analysis is delivered to the Legislature. As a result, a policy issue may have already been resolved before any findings are ever made. In addition, much of the work on PARs is conducted without legislative input. While current law requires the Legislature to approve the list of PARs, no further legislative input is sought for over 18 months.

Interim Reporting Requirements

The Legislative budget would establish several reporting requirements to update the Legislature on the overall status of the budget. Each year after the completion of the fiscal year, the Department of Administration publishes an annual financial report on the state's overall financial condition, including an estimate of the General Fund ending balance. This report usually takes five months after the fiscal year to produce. To provide more timely information on the state's fiscal condition, the Executive would now be required to report a preliminary estimate of the ending balance by September 1 following the end of the fiscal year. This preliminary estimate would be limited to the ending balance estimate and would not include any individual agency detail.

The reporting of the ending balance can also lead to re-estimates of available revenue. The budget is often enacted by March of each year, prior to the most important individual income tax collection months. As a result, there can be significant revenue re-estimates subsequent to the enactment of the budget. To keep the Legislature apprised of any substantial revenue revisions, the JLBC Staff would be required to report if budgeted revenues are expected to change by more than $50 million. This report would be due by September 30th of each year. The Executive may also provide their revenue re-estimate by this same date.